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THE MYTH OF COMPETITION IN THE DUAL BANKING SYSTEM

Henry N. Butler† *& Jonathan R. Macey*††

The American banking system operates under a dual state and federal system of chartering and safety and soundness regulation. The dual banking system ostensibly allows banks operating in any state to choose between two different sets of primary laws to define their powers and to regulate their activities and investments. Banks may obtain a national charter and fall under the regulatory aegis of the Comptroller of the Currency, or they may obtain a state charter from the chartering state's primary banking regulator and fall under its regulatory aegis. In addition, within this system state banks can further decide whether to subject themselves to federal regulation by becoming members of the Federal Reserve System (Fed) or by insuring deposits through the Federal Deposit Insurance Corporation (FDIC).

The ideal of the dual banking system, with its overlapping system of state and federal regulation, is perhaps unique in the support it enjoys in the political and scholarly communities. Principal proponents of the economic approach to legal problems regard it as a promising source of efficient legal rules.[1] This efficiency results from competition among state and federal regulators who desire to increase their market share by attracting additional chartering business.[2] Thus, the currently accepted theory posits that competition among state and federal regulators manifests itself in the maximum freedom from regulation consistent with a safe and sound banking system.[3]

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1 Scott, *The Dual Banking System: A Model of Competition in Regulation*, 30 STAN. L. REV. 1, 13 (1977).

2 *Id.* at 30 ("A strong conversion trend in favor of one regulatory system seems to induce secondary responses by the alternative regulatory agencies.").

3 For a recent defense of the dual banking system, see G. BENSTON, R. EISENBEIS, P. HORVITZ, E. KANE & G. KAUFMAN, PERSPECTIVES ON SAFE AND SOUND BANKING: PAST,

At the same time, there is such widespread political support among regulators and politicians for the dual banking system that "questioning the underlying premise of the dual banking system has traditionally been outside the borders of permissible political discourse."[4] Indeed, the dual banking system "has long been a sacred cow in the American political tradition."[5]

The thesis of this Article, however, is that the efficiency justifications for the dual banking system are entirely misplaced. We find that the substantive differences between federal and state chartering regulations are far more apparent than real. Federal preemption and uniformity, rather than competition and diversity, are the legal norms in banking regulation.

This Article begins with a background discussion of the history and a theoretical analysis of the dual banking system. Section I presents a brief history of the origins of the dual banking system, and Section II provides a discussion and critique of the supposed merits of the system. Our analysis demonstrates that the conventional view of competition in the market for bank charters is flawed in that the providers of charters are uniquely situated to restrict their supply.

In Section III, we present evidence that refutes the presumption that state regulation provides a meaningful alternative to federal regulation for banks in the United States. We show that several factors, particularly federal preemption under the Supremacy Clause, the practical competitive necessity of obtaining federal deposit insurance, the competitive equality doctrine, and state "wild card" statutes, discourage the provision of diverse legal rules and

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PRESENT, AND FUTURE 276-78 (1986) [hereinafter G. BENSTON, ET AL.]. *See also Consolidation of Bank Examining and Supervisory Functions: Hearings on H.R. 107 and H.R. 6885 Before the Subcomm. on Bank Supervision and Insurance of the House Comm. on Banking and Currency*, 89th Cong., 1st Sess. 178 (1965) [hereinafter 1965 *House Hearings*] (statement of Ralph Zaun) (dual system presented "opportunity to escape arbitrary supervision"); *id.* at 182 (statement of Archie K. Davis) (dual system prevents hanking regulation from becoming "oppressive or unduly restrictive and therefore inimical to the public interest"). As one commentator noted,

> [T]he historic value of dual banking lies in its ability to provide an escape valve from arbitrary or discriminatory cbartering and regulatory policies at either the state or Federal level.
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> . . . One of the historic objectives of dual banking has been to provide alternative supervisory frameworks under which commercial banks may chose to operate, thereby safeguarding against the extension of harsh, oppressive, and discriminatory supervision to institutions without recourse to alternative arrangements.

W. BROWN, THE DUAL BANKING SYSTEM IN THE UNITED STATES 59, 64-65 (1968), *quoted in* Scott, *supra* note 1, at 12.

[4] Miller, *The Future of the Dual Banking System*, 53 BROOKLYN L. REV. 1, 1-2 (1987).

[5] *Id.* at 1.

have lead to federally-imposed uniform regulations. We also show that to the extent that state and the federal regulators actually compete with one another, their competition takes the form of anticompetitive restrictions on entry into the banking industry rather than regulatory forbearance.

In Section IV, we develop a new theory, based on the economic theory of regulation,[6] of the structure and the continued vitality of the dual banking system. In our view, the dual system survives not because it generates efficient banking regulations, but because it provides an efficient structure for extracting the maximum amount of economic rents from political supplicants.

We show that the dual banking system is best viewed as a federal regulatory scheme, because Congress makes the all-important determination of how to allocate regulatory decisionmaking power. In our model, Congress delegates the authority to regulate banks not only to federal regulators such as the FDIC and the Comptroller of the Currency, but also to individual states and state banking authorities. Such delegations maximize political rents to Congressmen. The regulatory outcomes generated by the dual banking system appear to be cooperative rather than competitive, because Congress has divided up the regulatory turf of the relevant state and federal agencies in the way most beneficial to the groups that the system regulates. Congress uses its threat of preemption to force the states to accept their limited role in the regulation of banks.

In our view, whether state or federal law controls a particular aspect of banking regulation is the by-product of a complex interplay among those interest groups that the regulation affects. Thus, for example, allowing state law to control most aspects of a bank's decision to branch permits state banking supervisors and small banks to protect local banking cartels that restrict output and raise prices for consumers.[7] In contrast, competition in the capital markets is conducted on a national level, and here the relevant interest groups demand uniform regulations across all jurisdictions, an outcome best attained by having federal rules control.

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6 *See generally* Peltzman, *Toward a More General Theory of Regulation*, 19 J.L. & ECON. 211 (1976); Posner, *Theories of Economic Regulation*, 5 BELL J. ECON. & MGMT. SCI. 335 (1974); Stigler, *The Theory of Economic Regulation*, 2 BELL J. ECON. & MGMT. SCI. 3 (1971); Tullock, *The Welfare Costs of Tariffs, Monopolies and Theft*, 5 W. ECON. J. 224 (1967).

7 At times the state and national banks want regulations supplied to them at the national level. At other times, however, they find state regulations desirable. Their preferences vary depending upon whether they benefit most by a single, uniform rule across the country or by a myriad of different rules among jurisdictions. Where they benefit by a single rule, the interest groups find federal regulation best because the cost of obtaining a single uniform rule is lower than the cost of obtaining 50 or so identical state law rules. But where the interest groups benefit most by a variety of state law rules, they prefer state regulation. *See infra* notes 122-29 and accompanying text.

Thus, our theory posits that, while the *academic* support for the dual system may have its origins in a misconception of the quality of competition that actually exists between state and federal banks, the *political* support for the dual banking system is grounded upon the very realistic economic concerns of existing state and federal banks who would lose almost the total franchise value of their charter if the dual system were replaced with a system not based on geographic market segmentation. The real beneficiaries of the current system, and thus its primary defenders in the political arena, are existing banks and banking regulators. The theoretical section concludes with a discussion of the stability of the dual system, and its accompanying political equilibrium, in the face of major technological changes, product developments by nonbanking competitors, and international competition.

In Section V we discuss whether competition among state and federal regulators is preferable to federal control (i.e., monopolization) of all banking regulations. The current literature on the banking system assumes that such competition would benefit consumers because it would lead to regulatory forbearance and to the efficient production of legal rules.[8] We argue that, contrary to the assertions currently made about the benefits of a dual banking system, under the current FDIC insurance system, there is no legitimate role for state regulation of bank activities. If real competition did exist, it would encourage state regulators to compete in an unproductive competition in laxity.[9] We argue that FDIC insurance causes banks and depositors located in other states to bear most of the effects of one state's unsound regulation. In other words, fixed premium federal deposit insurance allows state banking regulators to impose costs on banks in other jurisdictions by permitting local banks to engage in excess risk taking. This argument supports the preemption of states from bank regulation. Thus, we not only fail to find any evidence of the regulatory competition that the supporters of the dual banking system envision, we find that such competition would harm the economy if it did exist under the current regulatory infrastructure in banking.

Next, we consider whether any alteration of the current banking regulation system would generate the same kind of productive competition that occurs when states compete in the provision of general corporate charters. In this regard, the keys to any reform of the

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[8] *E.g.*, Scott, *supra* note 1.

[9] We argue that federal regulations have preempted most areas of potential competition between state regulators. Our point here is that, in the absence of federal preemption, a harmful form of state competition could develop. For another view on the allegedly harmful nature of jurisdictional competition, see *infra* note 22.

dual banking system are the imposition of risk-related deposit insurance rates and the destruction of all barriers to interstate branching by banks. Risk-based insurance rates would correct the current tendency of state laws to deviate from market-determined levels of safety and soundness regulation. This would enable banks to select the optimal state law and operate in any state. Because banks would bear the costs of their excessive risk-taking, state regulators would have incentives to pass laws limiting excessive risk-taking in order to reduce the cost of capital of locally chartered banks. This approach provides great promise both for capturing the economic benefits of interstate banking and for destroying the regulatory cartel that has served to staguate banking laws.

The regulatory changes we propose are far-reaching, and beneficiaries of the current regulatory structure may be reluctant to embrace them. Yet true competition among regulators can make the benefits that the dual banking system promises a reality.

I
THE HISTORICAL BACKGROUND OF THE DUAL BANKING SYSTEM

The existence of the dual banking system is an historical accident in the truest sense of the word. Congress first authorized national banks with the National Bank Act of 1863,[10] not to provide an alternative source of regulation for prospective bankers, but to provide the nation with a stable system of currency to replace the existing system of notes issued by state banks, and to provide a ready market for the new bonds the federal government was issuing to finance the Civil War.[11] Indeed, those who drafted the enabling legislation thought that existing banks soon would exchange their state charters for federal charters and that a dual banking system would exist only during a brief transition period.[12]

When state bankers showed a reluctance to give up their state charters, Congress attempted to destroy the state system by imposing a punitive tax on state bank notes.[13] This failed only because state banks were able to offer checking accounts as low cost substitutes for the bank notes.[14] Thus, as Geoffrey Miller has observed, "The creators of the dual banking system . . . were hardly bent on

10 Miller, *supra* note 4, at 13.

11 National Bank Act of 1863, ch. 58, 12 Stat. 665, *repealed by* National Bank Act of 1864, ch. 106, § 62, 13 Stat. 99, 118 (codified as amended in scattered sections of U.S.C. (1982 & Supp. III 1985)).

12 B. HAMMOND, BANKS AND POLITICS IN AMERICA: FROM THE REVOLUTION TO THE CIVIL WAR 720-28 (1957).

13 Miller, *supra* note 4, at 14.

14 *Id.*

establishing the overlapping scheme of state and federal chartering that we observe today."[15]

From an interest group perspective, then, it seems that Congress began chartering banks because it wanted to capture some of the advantages associated with being the monopoly provider of bank charters.[16] In this regard, the predatory efforts to destroy the state banks reflect Congress's entrepreneurial skill. Congress, frustrated in its attempts to destroy its competitors in the market for bank charters, developed alternative avenues for regulating the competitors—punitive taxes—that reduced the attractiveness of state charters as substitutes for national charters.[17]

A complementary explanation is that Congress began chartering banks because there was real doubt about the constitutional authority of Congress to regulate the affairs of state chartered banks. Federal chartering was the only plainly constitutional avenue enabling Congress to regulate banks.[18] Under current constitutional principles, of course, Congress unquestionably has full authority to regulate the activities of state chartered banks under the commerce clause.[19] Moreover, if there were any doubt about this, the federal government could always make compliance with its regulations a *quid pro quo* for obtaining federally-sponsored deposit insurance. Because such insurance is a competitive necessity for banks,[20] it provides an avenue through which the federal government effectively can regulate state bank activities.

Thus, from both an interest group and historical perspective, the federal government began chartering banks because it wanted to regulate them. Congress envied state legislators who captured all the rents from allocating charters. If Congress had thought that it could accomplish its objectives by directly regulating state banks, there is every indication that it would have done so.[21] The dual

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15 *Id.*

16 We may safely infer this because such a result was almost certain at the time the legislators acted. *See generally* Stigler, *supra* note 6 (infer legislative intent from the probable consequences of the action).

17 *See* G. Anderson, W. Shughart & R. Tollison, A Puhlic Choice Theory of the Great Contraction 3 (June 1987) (unpublished manuscript on file at *Cornell Law Review*) (argning that unwillingness of central bank to prevent Great Depression by serving as backup source of liquidity for monetary system reflected its desire to eliminate nonmember banks from system).

18 The Court had upheld the authority of Congress to charter national banks in McCulloch v. Maryland, 17 U.S. (4 Wheat.) 316 (1819). *See generally* D. CURRIE, THE CONSTITUTION IN THE SUPREME COURT: THE FIRST HUNDRED YEARS, 1789-1888 at 160-89 (1985).

19 Miller, *supra* note 4, at 14.

20 *See infra* notes 89-90 and accompanying text.

21 *Cf.* Miller, *supra* note 4, at 14 ("The history [of federal chartering] . . . provides little or no support for the continued viability of the dual banking system.").

banking system is an early, and only partially successful, attempt by Congress to take complete control of the regulation of the nation's banking industry by making an end-run around an existing state-oriented system of banking regulation.

II
A Critique of the Supposed Merits of the Dual Banking System

The conventional analysis of the dual banking system is premised on the existence of effective competition among regulators.[22] According to this analysis, the dual banking system leads to more efficient regulations because competition between the state and national regulators limits the imposition of unnecessarily burdensome regulations, controls the abuse of discretion by regulators, and encourages the development of the most liberal banking powers consistent with the safety and soundness of the banking system.[23]

Under the conventional analysis, this competition supposedly manifests itself through competition for control of the market for bank charters.[24] The hallmarks of the alleged competition between

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22 *See generally* Scott, *supra* note 1. The current regulatory system does have its critics, including those who see competition in the dual banking system as harmful. In contrast to the beneficial effects of competition, the competition between national and state bank regulators allegedly creates a "competition in laxity." *See, e.g.*, Address of Arthur Burns, Chairman of the Board of Governors of The Federal Reserve System, Maintaining the Soundness of Our Banking System 18-19, American Bankers Association Convention, Honolulu, Hawaii (Oct. 21, 1974) ("The present regulatory system fosters what has sometimes been called 'competition in laxity.' . . . I need not explain to bankers the well-understood fact that regulatory agencies are sometimes played off against one another."), *quoted in* Scott, *supra* note 1, at 13. This criticism is similar to the alleged "race for the bottom" in corporation law. *See, e.g.*, Cary, *Federalism and Corporate Law: Reflections Upon Delaware*, 83 YALE L.J. 663 (1974). In general, the response to this allegation is the same for banking as for corporation law—the managers of the firm have an economic incentive to maximize the value of the firm and thus select the set of regulations that achieves that goal. *See, e.g.*, Scott, *supra* note 1, at 13; *see generally* Baysinger & Butler, *The Role of Corporate Law in the Theory of the Firm*, 28 J.L. & ECON. 179 (1985).

23 *See* Scott, *supra* note 1; G. BENSTON, ET AL., *supra* note 3; 1965 *House Hearings*, *supra* note 3.

24 Professor Scott's underlying thesis is that both state and federal regulators are concerned about the size of the turf they control. Although Scott's evidence seems to support this view of regulatory behavior, he does express some doubt about the richness of his economic model:

> Under an economic model of the dual banking system, the regulatory agencies can be viewed as firms producing different brands of regulation and engaged in a species of competition for market shares. The analogy to the behavior of private firms in private markets, however, should not be pushed too far. Our knowledge of government regulation and bureaucracy does not permit us to construct with confidence well-specified models of the behavior of bank supervisory agencies. Models of profit maximization, empire building or power aggrandizement do not seem to fit too well. Banking agencies apparently respond more vigorously to the loss of existing members than to the prospects of obtaining new mem-

banking systems are (1) the ability of banks to select among differing sets of banking laws and (2) bureaucratic incentives to tailor regulations in order to hold onto their system's share of the chartering market. This section demonstrates that these operational assumptions about competitive interaction in the dual banking system are false.

A. The Market for Bank Charters and the Principle of Choice

The first step in discussing the market for bank charters is to recognize that the options available to firms in the banking industry are very limited. The dual banking system limits direct competition between the regulation of national banks and the regnlation of state banks to the geographic territory of the state in which either a bank is chartered or granted permission to operate.[25] Thus, as we detail in the following two subsections, a firm seeking to entèr the banking industry in any state is limited to two chartering options and an existing firm has only one choice for charter conversion when dissatisfied with the other regulators.

1. *Chartering*

Whenever a firm must have a "charter" or "license" to enter an industry or a particular geopolitical segment of an industry, entry into the industry—and thus competition—is impeded.[26] In fact,

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> bers; behavior is more defensive than aggressive, and a Saxon stands out as atypical.

Scott, *supra* note 1, at 32-33 (footnote omitted). This schizophrenia reflects the tensions of the regulatory environment. From an interest group perspective, the defensive posture results from the primary goal of banking regulation—the restriction of entry into specific geographic markets. The tendency for banking agencies to respond to losses or threatened losses could evidence the capture of the state agency by the banks it regulates and that those banks find it less costly to influence the content of the law than to convert charters. Moreover, state banks prefer a regulatory structure responsive to their needs, and conversion to a national bank would change a relatively large state bank into a moderate national bank with a corresponding reduction in influence over national bank regulatory agencies.

25 The McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 36 (1982)), prohibits national banks from branching across state lines.

26 Banking regulators have siguificantly reduced new bank entry. *See generally* Edwards & Edwards, *Measuring the Effectiveness of Regulation: The Case of Bank Entry Regulation*, 17 J.L. & ECON. 445 (1974); Peltzman, *Entry in Commercial Banking*, 8 J.L. & ECON. 11 (1965). Numerous public interest reasons for regulating banking—for example, to promote safety and soundness of banks and the banking system and to provide for monetary stability—have been articulated over the years. However, restricted entry is not necessary to achieve the articulated "public interest" goals of banking regulation. For example, risk-sensitive deposit insurance meets the need for safety and soundness. *See, e.g.*, Garrison, Short & O'Driscoll, *Financial Stability and FDIC Insurance*, in THE FINANCIAL SERVICES REVOLUTION: POLICY DIRECTIONS FOR THE FUTURE 187 (C. England & T. Huertas, eds., 1988) [hereinafter THE FINANCIAL SERVICES REVOLUTION].

statutorily imposed entry barriers such as licensing and chartering restrictions are a hallmark of special-interest legislation.[27]

Obtaining a bank charter, unlike obtaining a general corporate charter, is not a matter of right.[28] Rather, the process is long, drawn out, and expensive. The Comptroller of the Currency, who has the authority to grant or deny national bank charters, can deny a charter application if he thinks that the bank's future earnings prospects are poor,[29] if he thinks that the new bank will not meet the convenience and needs of the community,[30] or even if he thinks poorly of the "general character" of the bank's management.[31]

The process of obtaining a bank charter often takes a year or more,[32] "and, even then, there is no guarantee that the [charter] will be approved."[33] Indeed, not only is there no guarantee of receiving a charter, but the procedures the Comptroller uses to determine whether to grant a charter do not seem to conform to any predictable standards, thereby making it impossible to predict whether the Comptroller will approve a particular application.[34]

A traditional argument in support of the dual banking system is that competition among the regulators will induce regulators to exhibit flexibility in granting charters.[35] The evidence, however, does not support this contention. Since the Great Depression, the number of banks in the United States has remained remarkably constant,[36] a testament to the ability of the federal regulators to restrain entry.[37] The fact is that bank regulators are insulated from competi-

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27 Easterbrook, *The Supreme Court, 1983 Term—Foreword: The Court and the Economic System*, 98 HARV. L. REV. 4, 45 (1984) ("licensing statutes are the playgrounds of interest groups").

28 This need not necessarily be the case. There is no efficiency or safety-and-soundness reason why obtaining a bank charter could not become a matter of right, provided other specified public policy objectives are met.

29 12 C.F.R. § 5.20(c)(1) (1987).

30 *Id.* § 5.20(c)(4).

31 *Id.* § 5.20(c)(2). The Comptroller's extraordinary power to grant or deny bank charters is derived from 12 U.S.C. § 1816 (1982).

32 E. SYMONS & J. WHITE, BANKING LAW 68 (2d ed. 1984).

33 *Id.*

34 *See* Scott, *In Quest of Reason: The Licensing Decisions the Federal Banking Agencies*, 42 U. CHI. L. REV. 235 (1975). Scott decries the lack of communication among the various participants within the Comptroller's office on the decision to grant or deny a bank charter and describes the lack of discussion of, or agreement on, the underlying premises that inform the chartering decision. He concludes that until there is better communication and agreement on the underlying premises, "the Comptroller's decision process will never be comprehensible, either internally or externally." *Id.* at 284.

35 *E.g.*, Scott, *supra* note 1, at 34 ("One of the reasons that new entry in banking has not been stifled as effectively is that entry is not controlled by a single agency.").

36 C. GOLEMBE & D. HOLLAND, FEDERAL REGULATION OF BANKING 1986-87, at 96, 99 (1986).

37 Of course, the number of banks does not indicate the extent of marketplace competition because a restricted number of banks can compete with one another by opening

tive pressures.[38] In contrast to the market for charters of general corporations, neither state bank regulators nor the Comptroller receive the same benefits from attracting bank charters that legislators in Delaware receive from attracting additional corporate charter business.[39] And, unlike the competition among states for general corporate charters, state bank regulators do not compete against one another for bank charters because banks must obtain a charter from the jurisdiction in which they do business.[40]

2. *Charter Conversions*

Regulated firms must be able to switch easily from one regulator to another in order to obtain the benefits of competition among regulators.[41] For banks, however, switching from a state to a federal charter is far more difficult than the process, familiar to general business corporations, of switching charters by simply changing the state of incorporation.

Ignoring the practical difficulty of obtaining a charter from a "rival" regulator,[42] the existing literature instead focuses on the ability of banks, at least since 1950, to convert their charters from one governmental agency to the other without obtaining the permission of their current chartering agency. Thus a state chartered bank can switch to a national bank charter without the permission of the relevant state regulator, and a national bank can convert its

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additional branch offices in states where branching is permitted. The stability of the total number of banks does suggest that regulators are not responding to any theorized incentives to increase the number of banks.

38 *See infra* notes 67-120 and accompanying text. In addition, we note that the major factors that give rise to competition among private firms—product market competition, internal rivalries among managers, capital market discipline and the market for corporate control—do not exist to guide the behavior of banking regulators.

39 *See* Macey & Miller, *Toward an Interest-Group Theory of Delaware Corporate Law*, 65 TEX. L. REV. 469 (1987).

40 The market for corporate charters highlights the failure of the dual banking system to encourage responsive state chartering of banks. The relatively high proportion of Delaware's revenue that comes from its brisk sales of corporate charters guarantees that it will maintain a regulatory climate hospitable to chartering firms. As Roberta Romano has pointed out, Delaware's dependence on chartering revenues forms a bond that provides assurance to firms locating there that the state will not change its laws so as to disturb the legal climate for locally chartered firms. Romano, *Law as a Product: Some Pieces of the Incorporation Puzzle*, 1 J.L. ECON. & ORGANIZATION 225 (1985).

41 This is an essential premise for advocates of the dual banking system. *See supra* notes 1-3 and accompanying text. For a discussion of the economics of jurisdictional competition, see *infra* note 45.

42 Even when Comptroller Saxon instituted his (relatively) generous chartering policy in the early 1960s, *infra* note 62, very few state banks converted to national charters. For a detailed study of charter conversions, see Miller, *An Analysis of Chartering and Conversions*, 1960-1977, in 2 STATE AND FEDERAL REGULATION OF COMMERCIAL BANKS 489 (L. Lapidus ed. 1980).

charter to a state charter without the consent of the Comptroller.[43] Because this "legal structure permits financial institutions to select their chartering authority at any time, even over the objection or resistance of the chartering authority they are leaving,"[44] it is argued that regulators must respond to the needs of the banks they regulate in order to prevent a loss of market share to the rival chartering authority. Professor Scott goes so far as to argue that "one indisputable point . . . is that the dual banking system is a dynamic and interactive regulatory structure, so that a change in the content or effect of regulation in one sector releases a series of forces."[45]

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43 Act of August 17, 1950, ch. 729, 64 Stat. 455 (codified as amended at 12 U.S.C. § 214-214c (1982). This statute permits national hanks to convert into or merge with or consolidate into a state bank without the Comptroller's permission, so long as that particular avenue of transfer is permissible for a state bank wishing to obtain a national bank charter. *See* Ellis v. State Nat'l Bank, 434 F.2d 1182 (5th Cir. 1970), *cert. denied*, 402 U.S. 973 (1971).

44 Scott, *supra* note 1, at 11.

45 *Id.* at 35. In most areas of economic activity, competition tends to produce the efficient or optimal allocation of resources. Economists have generated a set of four necessary conditions that must be fulfilled in order for competition among political jurisdictions to produce optimal laws. *See generally*, Easterbrook, *Antitrust and the Economics of Federalism*, 26 J.L. & ECON. 23 (1983); Epple & Zelenitz, *The Implications of Competition Among Jurisdictions: Does Tiebout Need Politics?*, 89 J. POL. ECON. 1197 (1981); Kolstad & Wolak, *Competition in Interregional Taxation: The Case of Western Coal*, 91 J. POL. ECON. 443 (1983); Rose-Ackerman, *Does Federalism Matter? Political Choice in a Federal Republic*, 89 J. POL. ECON. 152 (1981); Tiebout, *A Pure Theory of Local Expenditures*, 64 J. POL. ECON. 416 (1956).

First, the economic entities affected by the law must be mobile and able to move to alternate jurisdictions at a relatively low cost. This first condition corresponds to Hirschman's "exit" option. *See* A. HIRSCHMAN, EXIT, VOICE AND LOYALTY (1970). Hirschman has generalized the concept of social control of decisionmaking into the dichotomous exit voice framework which is adaptable to the economics of jurisdictional competition. The exit option refers to the anonymous withdrawal from dealings with decisionmakers in response to dissatisfaction with their decisions. The voice option appears in normal product markets in the form of complaints, lawsuits, and so forth. The voice option is also associated with the political process. The exit option, which is most often associated with normal product markets where consumers can easily switch producers, is also an important means of registering displeasure with the political process. Besides switching their political affiliations, voters can "vote with their feet." *See generally* Tiebout, *supra*.

Second, jurisdictions must be able to select any set of laws they desire. Third, all of the consequences of one jurisdiction's laws must be felt within that jurisdiction. Fourth, lawmakers must tend to respond to adverse consequences, such as falling population, market share, or revenue, that result from inefficient regulations.

In recent years, the economics of jurisdictional competition has been applied to competition between the states for the lucrative corporate cbartering business. *See, e.g.*, Baysinger & Butler, *supra* note 22; Baysinger & Butler, *Race for the Bottom v. Climb to the Top: The ALI Project and Uniformity in Corporate Law*, 10 J. CORP. L. 431 (1985); Butler, *Nineteenth-Century Jurisdictional Competition in the Granting of Corporate Privileges*, 14 J. LEG. STUD. 129 (1985); Dodd & Leftwich, *The Market for Corporate Charters: "Unhealthy Competition" versus Federal Regulation*, 53 J. BUS. 259 (1980); Easterbrook, *supra*, at 34-35; Fischel, *The Corporate Governance Movement*, 35 VAND. L. REV. 1259 (1982). *Contra* Cary, *supra* note 22, at 663. A consensus is emerging among economists that such competition tends to

This argument is flawed, and any comparison to the jurisdictional competition among states for the chartering business of general corporations is misleading. The argument ignores the difficulty faced by a bank when it attempts to obtain a charter from the rival agency. Further, unlike corporation law where nonbanking firms may select among fifty-one jurisdictions regardless of the location of their headquarters, banks have only two chartering choices—a national charter or a charter from the state where they locate their headquarters.[46] And, unlike the dynamic of standard competitive markets, it seems inaccurate to view banking regulators as "firms producing different brands of regulation and engaged in a species of competition for market shares."[47]

A state chartered bank is unlikely to find that converting to a national bank charter will result in an enhanced ability to influence its regulators. In all likelihood, such a charter conversion would transform a relatively large state bank into a moderate or small national bank and correspondingly reduce the bank's relative influence over the relevant regulatory agencies.

Nor is the threat of a switch by a national bank to a state charter in response to a liberalized state law likely to galvanize federal regulators into action. National banking regulators are unlikely to respond to every change in state law because isolated changes can have only a small impact on the entire national bank share. And in those rare instances when state authorities impose a genuine threat to federal regulators,[48] the federal regulators can trump the state officials by passing laws applicable to all banks,[49] or by making conformity to their demands a *quid pro quo* for continued eligibility for federal deposit insurance.[50] Thus, to the extent that interstate banking leads to competition among the states, it can also lead to

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generate the optimal set of corporate laws. We argue, however, that several major institutional constraints on the production of efficient banking regulations have prevented the realization of the potential benefits of jurisdictional competition.

46 As interstate banking slowly becomes a reality, the possibilities of true jurisdictional competition—competition among co-equal regulatory authorities (states)—become greater. *See* Miller, *supra* note 4, at 7. But to the extent that federal agencies significantly regulate banking, the state law is irrelevant.

47 Scott *supra* note 1, at 32.

48 *See infra* notes 67-88 and accompanying text.

49 In a few specific instances, such as the emergence of "NOW" accounts, states have effectively pushed federal regulators to adopt more liberal regulations. See G. BENSTON, ET AL., *supra* note 3, at 276-77.

50 This is the precise effect of section 101(c) of the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, 101 Stat. 552, 560, which by amending section 4 of the Bank Holding Company Act of 1956, ch. 240, 70 Stat. 133, applies for the first time Glass-Stegall prohibitions concerning investment banking activities to *all* banks insured by the FDIC. *See infra* notes 81-82 and accompanying text.

increased federal regulation.[51]

In addition, the analogy between the dual banking system and the jurisdictional competition for general corporate charters is inappropriate because banking regulators in one state do not have strong incentives to respond to changes in state banking regulations in other states. Regulations covering banks' depository activities, such as reserve requirements and branching restrictions, have only a small extraterritorial effect, and consequently do not threaten the market share of regulators in other states.[52]

B. The Current Theory of Bank Regulatory Agency Behavior

In his seminal article on the economics of the dual banking system, Professor Scott offered several tentative conclusions on the impact of competition among banking regulatory agencies.[53] First, competition forces agencies to move in the direction of broader operating authority—such as the erosion of limitations on competition with nonbank enterprises—so as to increase the profitability of banks. Importantly, however, this observation is also consistent with a regulatory regime in which the banking industry captures the regulators. Much of the recent expansion in banking powers, which has generally benefited the banking industry, has occurred through agency liberalization and judicial interpretation. This expansion has come at a time when banks are faced with increasing competition and loss of market share to nonbank suppliers of financial services and foreigu banks.

Second, Scott described a scenario in which the competing regulatory agencies were unlikely either to raise or lower the level of regulations desigued to protect depositors (and/or the deposit insurer) from bank failures—such as regulations related to capital adequacy, lending limits, and reserve requirements.[54] According to Scott, an agency is unlikely to raise standards unilaterally for fear of losing some of its market share to other regulators and unlikely to lower standards unilaterally for fear of political repercussions if

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51 Such a result would not necessarily be detrimental under the current, flawed system of federal deposit insurance. *See infra* text accompanying notes 89-92.

52 However, changes in the regulation of nondeposit activities in one state can lead to changes in other states. State A can siphon off nondeposit business from State B by offering more liberal activity regulation. In fact, Delaware and South Dakota have done this fairly successful in the regulation of credit cards. The home state is likely to experience pressure to loosen its own regulations in order to prevent loss of business to these competitors.

53 Scott, *supra* note 1, at 33-36.

54 This equilibrium resembles that associated with sticky prices in oligopoly theory and, thus, suffers from the same criticism—the theory fails to explain the selection of initial regulations.

some banks were to fail under the lower standards.[55] This scenario represents classic risk-averse bureaucratic behavior.[56] From the bureaucrat's perspective, a successful move generates only a small payoff, but creates the potential for serious adverse consequences should a change in regulatory structure be perceived as leading to bank failures.[57]

In this regard, Professor Scott recoguizes that competition among banking regulators does not bear the indicia of perfect competition, and instead views state and federal bank regulators as members of an inherently unstable cartel of regulators all of which provide bank regulations. Scott summarizes his view of the productive role of competition among state and federal regulators as follows:

> In short, the dual banking system prevents the formation of a single industry cartel policed through the rules and powers of a single government agency. The closest analogy to the dual system is a situation akin to oligopoly, involving competing cartels. As banking history and economic theory suggest, in such a situation efforts at coordination of policies continually are made and regularly break down, because of the gains some banks and their supervisors can reap from violating the policy restraining competition and because of the difficulty of punishing "violators" effectively.[58]

While cartel theory does suggest that cartels are inherently unstable because of members' incentives to cheat, cartel theory also identifies conditions under which cartels are most likely to survive over time.[59] In general, cheating on a cartel is least likely to occur when: (1) the number of producers is small; (2) it is easy to detect cheating; or, (3) where a government agency is willing to impose legal sanctions on those who cheat. Where all three of these conditions exist, cartels can enjoy long term stability.

The banking industry is especially conducive to the long-term stability of a regulatory cartel. Within each relevant market, there

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55 Scott, *supra* note 1, at 34.

56 On the other hand, federal deposit insurance gives state banking regulators the incentive to take excessive risks because the costs of any bank failures are borne nationally, not locally. *See generally* Miller, *supra* note 4, at 19.

57 The duopoly that characterizes the market for banking charters could implicitly, and without any communication or agreement among chartering authorities, restrict the granting of charters to levels similar to those that would result from monopoly. *See generally* F. SCHERER, INDUSTRIAL MARKET STRUCTURE AND ECONOMIC PERFORMANCE 131-45 (1970). A duopoly's propensity to restrict output is the next closest to that imposed by a monopoly. Moreover, there is considerable (generally cooperative) interaction between state and national bank regulators.

58 Scott, *supra* note 1, at 35 (footnote omitted).

59 *See* R. POSNER, ECONOMIC ANALYSIS OF THE LAW § 10.1 (3d ed. 1986).

are only two producers of charters. The division of the national market for bank charters into fifty-one separate geographic markets facilitates the maintenance of a regulatory cartel.[60] In addition, their products are relatively standardized and information about regulatory differences is a matter of public record so that detecting cheating is easy. Finally, the federal government can enforce the cartel by imposing the legal sanction of required uniformity on any state that attempts to cheat.[61] Thus, cartel theory suggests that the dual banking system is likely to be a model of cooperative behavior between the state and the federal regulators. Indeed, the cartel has been relatively stable and successful in restricting output over time.[62]

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60 *See infra* notes 121-29 and accompanying text. Geographic segmentation makes the enforcement of cartel agreements less difficult and facilitates price discrimination.

61 *See infra* notes 67-91 and accompanying text.

62 The fact that the one known example of cheating on the cartel is notorious in the banking literature suggests that the cartel is stable. The impact of the tenure of James Saxon, Comptroller of the Currency from 1961 to 1966, is often cited as evidence of the dynamic nature of the dual banking system. *E.g.*, Scott, *supra* note 1, at 23-30. Comptroller Saxon was a strong supporter of national banks and implemented a relatively liberal chartering policy. As a result of Saxon's relaxation of the chartering process, more national bank charters were approved—including a relatively large percentage of conversions from state to federal charters. For a description and analysis of the data, see *id.* Professor Scott described the impact of Saxon's policies as follows:

> As the attractiveness of one regulatory option increases because of policy shifts or other causes, institutions at the margin are induced to shift. After the initial shift, however, a new regulatory equilibrium is established, and conversion ceases unless policies or other factors continue to change. It is a fallacy to project such trends indefinitely, especially to a terminal point at which one of the regulatory systems is extinct. Furthermore, the dual system model is not static but dynamic. A strong conversion trend in favor of one regulatory system seems to induce secondary regulatory responses by the alternative regulatory agencies.

Id. at 30. Scott supports his thesis with several examples of the interaction of federal and state banking regulations. *Id.* at 3-8.

Comptroller Saxon's liberalization of the charter granting procedures suggests tbat the pre-Saxon Comptrollers as well as state chartering authorities had restricted entry and that the established banks were earning supracompetitive profits as a result of the legal barriers to entry into the banking industry. Saxon was once quoted as stating: " 'I probably made more new millionaires in those days than anyone else in the country.' " E. SYMONS & J. WHITE, *supra* note 32, at 88 (citing Shapiro, *Bank Charters: How He Got to Do It*, WASH. MONTHLY, July-Aug. 1973, at 41 (quoting Saxon)). This observation, however, has little to do with the substantive content of the laws governing national, as opposed to state, banks. In this regard, the popularity of Saxon's policy among newly-created banks was simply a reflection of frustrated demand for bank charters.

The response to Saxon's charter conversion policy suggests that some state banks in some states (Scott did not compare differences in conversion rates across states) preferred the national banking regulations to state banking regulations in their home state. This is especially revealing because Saxon's liberalization of chartering policy was not accompanied by significant changes in national bank regulations. Before Saxon's tenure, state regulators had no reason to concern themselves with the differences between state and national banking law because the conversion option was rarely available to state banks. For example, before Saxon's tenure, the Comptroller rarely granted charters to either new banks or state banks converting to national banks. In fact, one might

Thus, the characterization of the dual system as an unstable cartel that would tend to generate occasional dynamic episodes in banking law is untenable. In fact, closer analysis reveals that the relationship between state and federal regulators more closely resembles an iterative prisoner's dilemma[63] than an unstable cartel. For the two regulators, the best possible strategy is to cooperate so as to maximize their ability to extract the most political support from the banks they regulate.[64] To the extent that bankers can play regulators off against one another, they can reduce the power of the regulators; to the extent that the regulators can prevent bankers from engaging in that sort of behavior by agreeing to deprive them of any real choice among regulatory options, the regulators can enhance their relative power.

For each regulatory agency, the best possible outcome would allow it to impose precisely the rules it wants and compel the other agency to follow suit. This would enable the lead agency to capture all of the political rents associated with rulemaking. The worst possible strategy would be unfettered competition among the regulators. Thus the optimal strategy for the regulators in the dual banking system is to cooperate. Game theory predicts that in situations such as this, where the parties repeatedly deal with one another over time, the optimal strategy will dominate other outcomes.[65]

Thus, we reject Scott's cartel analysis because it is inconsistent with both cartel theory and game theory, as well as with the reality

conclude that the competition triggered by Saxon's liberal policies is the exception rather than the rule. *See, e.g.*, Scott, *supra* note 1, at 33 ("Saxon stands out as atypical"). One cannot properly infer a "dynamic" nature in the competition between national and state banking regulators from this apparently isolated episode in the history of banking regulation.

63 A prisoner's dilemma takes its name from the situation faced by two prisoner's whom the police interrogate separately. Each prisoner has two options: (1) admit nothing or (2) inform on his partner. If neither prisoner admits anything, then both may go free or face a light sentence because they will deprive the prosecutor of their evidence. If a prisoner confesses, the prosecutor will treat him with leniency. Thus, if one confesses while the other does not, the one who confesses will receive more lenient treatment, while the one who refused to confess will be treated harshly. Caught in this trap, rational prisoners will confess, even though they could achieve the best outcome if they had been able to cooperate with each other and refuse to confess. Similarly, in banking law if federal and state regulators cooperate they can achieve the best possible outcome—extraction of the greatest possible rents.

64 Bank regulators are faced with a choice of competing with one another or banding together to maximize the value of the franchises they regulate in order to generate more political support from legislators.

65 When the parties to a prisoner's dilemma, *see supra* note 63, are repeat players who do not know when the "game" will end, then they will rationally conclude that it is in their interest to cooperate as soon as possible to induce the other party to cooperate and achieve the optimal outcome. *See generally* P. ORDESHOOK, GAME THEORY AND POLITICAL THEORY: AN INTRODUCTION 442-48 (1986).

of agency practice over time. Assuming that the agencies are potential competitors in the production of banking laws, the superior theoretical characterization of the interaction of state and federal regulation is one of cooperation, not competition. But, in reality, federal regulators do not need to cooperate with state regulators on most regulatory issues because of the supremacy clause. In Section IV, we develop a more powerful theory of the organization of the dual banking system. We argue that federal banking regulators, possibly in response to concerns about competition from state regulators, have preempted every area of banking regulation where federal regulation is more effective than state regulation at aiding banks in achieving a regulatory environment that insulates them from competitive pressures.[66] The following section examines particular attributes of banking law and regulatory practice in order to test our hypothesis that the idea of competition in the dual banking system is a myth rather than a reality. We then present our new theory based on federal preemption.

III
EVIDENCE ON THE ABSENCE OF COMPETITION IN THE DUAL BANKING SYSTEM

The preceding analysis suggests that the generally accepted theory of competition in the dual banking system is flawed. This section bolsters that conclusion by providing evidence that whatever competition that may exist among regulators does not manifest itself in the form of regulatory forbearance as conventional analysis currently supposes.

At least five distinct forces work to prevent the realization of true regulatory competition in the market for bank charters. The first is the ability of the federal government, through the supremacy clause, to trump state regulation when doing so serves its interests. Second, as a matter of competitive necessity, both state and federal banks must obtain federally provided deposit insurance, and the FDIC requires that banks obtaining such insurance comply with its uniform regulations regardless of contrary provisions in the laws of individual states. The third force is the McFadden Act, which has prevented free interstate banking and thereby has allowed the segmentation of the nation into over fifty geographic markets. The fourth is the competitive equality doctrine, which requires national banks to follow state law when establishing branch banks. This enables state authorities to maintain local cartels and restrict competition among banks in certain geographical locations. The fifth force

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66 *See infra* notes 67-91 and accompanying text.

is the laws passed by a majority of states that automatically impose the regulations of national banks on state banks—the so-called "wild card" statutes. Thus, even in those situations in which Congress or the FDIC has refrained from mandating uniform standards, two additional sets of rules—the competitive equality doctrine and state "wild card" statutes—reduce competition among regulators in the provision of banking laws.

A. The Supremacy Clause

Perhaps the biggest flaw in the competitive view of the dual banking system is its failure to recognize that the federal government can respond to any loss of market share or regulatory control that results when states enact more efficient laws simply by imposing its own inefficient rules on those banks regulated by rival state agencies. Over time the federal government has passed preemptive legislation in the important areas of reserve requirements, separation of commercial banking from investment banking, and the regnlation of bank holding companies.

1. *Reserve Requirements*

Historically, the most significant advantage to being a state nonmember bank[67] was freedom from the reserve requirements that the Board of Governors of the Federal Reserve System imposes on its members.[68] Many banks found the reserve requirement so onerous that by the late 1970s the Federal Reserve System was losing

67 The term "state nonmember bank" refers to state chartered banks that are not members of the Federal Reserve System.

68 All national banks are automatically members of the Federal Reserve System. 12 U.S.C. § 222 (1982). State chartered banks may become members of the system upon successful application to the Board of Governors of the Federal Reserve System. *Id.* § 321.

Reserve requirements consist of bank assets held in the form of vault cash or deposits with one of the regional Federal Reserve Banks or—in the case of banks that are not members of the Federal Reserve System—deposits with certain approved member banks. Thus, reserve requirements obligate a bank to hold at least a specified percentage of its deposit liabilities in presumably safe and liquid assets. All banks in a fractional reserve system are vulnerable to runs because their assets are illiquid (e.g., mortgages and other long-term debt instruments), while their liabilities are relatively-liquid deposits. The goal of reserve requirements is to prevent bank liquidity problems that could lead to a bank run or runs. The regulatory concern is that a run on one bank will impose negative externalities on the banking system by shaking confidence in the entire banking system and lead to runs on other banks. *See generally* Kaufman, *The Truth About Bank Runs*, in THE FINANCIAL SERVICES REVOLUTION, *supra* note 26, at 9. In theory, a bank has as much interest in preventing a run on its deposits as the banking regulators themselves because the owners of the bank stand to lose their investment if a run occurs. Thus, even if the competition between regulators resulted in excessively low reserve requirements, banks would most likely hold reserves greater than the regulatory requirements.

members at record rates as state banks dropped out of the System.[69] According to the competitive model of the dual banking system, this regulatory imbalance should have led federal authorities to adjust to the relatively liberal state law rules and lower their reserve requirements. But, consistent with our preemption model of regulatory delegation, the federal response was to pass the Depository Institutions Deregulation and Monetary Control Act of 1980 which imposed the federal reserve requirements on all banking firms.[70] With the passage of the Act, federal law now requires all depository institutions offering transaction accounts to maintain reserves with the Federal Reserve System against all transactions accounts and nonpersonal time deposits.[71] By imposing this rule, Congress eliminated a major dimension of the competition within the dual banking system.

Reserve requirements exist to ensure that banks maintain a minimum degree of liquidity to meet unexpected depositor demand for funds.[72] Although the Federal Reserve's role as lender of last resort and deposit insurer mitigates the liquidity problems that plagued banks during the Great Depression, reserve requirements are nonetheless an important regulatory tool. Because a reserve requirement is equivalent to a tax,[73] the lower reserve requirements for state nonmember banks were very popular and were one of the main reasons cited for the departure of many medium-sized banks from the Federal Reserve prior to 1980.[74] Additionally, many state reserve requirements allowed the state banks to hold the reserves in interest-bearing securities, thereby further reducing the relative cost of state-composed reserve requirements.

The federal reserve requirement rule, which applies to all de-

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69 E. SYMONS & J. WHITE, *supra* note 32, at 75.

70 Pub. L. No. 96-221, 94 Stat. 132 (1980) (codified in scattered sections of 12 U.S.C.). For a public choice analysis of the impact of the Monetary Control Act, see Toma, *The Role of the Federal Reserve in Reserve Requirement Regulation*, in THE FINANCIAL SERVICES REVOLUTION, *supra* note 26, at 209, 225 ("the Monetary Control Act . . . enhances the wealth-extraction powers of the central government").

71 12 U.S.C. § 461 (1982). As a corollary to the imposition of reserve requirements, nonmember institutions can use federal reserve services that previously were available only to members. This seems reasonable given that the institutions must bear the primary cost of being a member of the Federal Reserve System—the cost of maintaining reserves that do not generate revenue. *See infra* note 73.

72 If a solvent bank is unable to meet its liquidity requirements and must sell some of its assets at "fire sale" prices, then the bank will lose its capital base and become insolvent. Thus, capital requirements alone do not generally suffice to meet the need filled by a lender of last resort.

73 The Federal Reserve System reserve requirements require that a certain percentage of the reserves be held in noninterest bearing accounts at the Federal Reserve Bank. The inability to earn interest on these liquid assets is an expropriation of wealth by a government agency, the equivalent of a tax.

74 *See supra* note 69.

pository institutions regardless of the source of their charters, in addition to requiring all depository institutions to maintain reserves with the Federal Reserve System, also allows the Federal Reserve to determine the level of those reserves.[75] In the face of fixed-premium, federally-sponsored deposit insurance, the decision to impose standardized minimum reserve requirements on all banks seems justified. The ability of state banking authorities, before 1980, to relieve banks of onerous reserve requirements gave state nonmember banks additional leeway to engage in excessive risk-taking (in the form of extremely illiquid asset portfolios) at the expense of the federal banking authorities. Put another way, the ability of state banking authorities to set the reserve requirements for federally-insured banks created a negative externality. All of the costs of the low state reserve requirements were borne at the federal level because riskier state banks placed an added burden on either the Federal Reserve as lender of last resort or the federal insurance fund. In contrast, all of the benefits of the low reserve requirements were enjoyed at the state level in the form of additional local loans at lower interest rates, higher interest rates for local depositors, and greater returns to shareholders in state-chartered, nonmember banks. Thus, not only does the dual banking system not function as envisioned, it does not appear that permitting states to regulate federally-insured banks is particularly desirable in the presence of fixed-premium, federally-sponsored deposit insurance. Such state regulation will likely permit state banks to engage in excessive risk-taking at the expense of the federal deposit fund.

2. *The Glass-Steagall Act*

Another example of the federal government's ability to trump state banking regulation manifested itself with the passage of the Competitive Equality Banking Act of 1987.[76] The Glass-Steagall Act of 1933[77] separates commercial banking from investment banking. From 1933 to 1987, however, significant portions of the Glass-Steagall Act applied only to national banks and to those state-chartered banks that chose to become members of the Federal Reserve System. State-chartered nonmember banks were not covered by the Act.

Of particular siguificance was the inapplicability of sections 20 and 32 of Glass-Steagall to state nonmember banks before 1987. Section 20 prohibits the affiliation of banks with organizations "en-

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75 12 U.S.C. § 461 (1982).

76 Pub. L. No. 100-86, 101 Stat. 552 (1987).

77 Ch. 89, 48 Stat. 162 (1933) (codified as amended in scattered sections of 12 U.S.C.).

gaged principally in the issue, flotation, underwriting, public sale, or distribution at wholesale or retail or through syndicate participation of stocks, bonds, debentures, notes or other securities."[78] Section 32 provides that no "officer, director, . . . employee, [or] partner [of any organization] primarily engaged in the issue, flotation, underwriting, public sale, or distribution . . . of stocks, bonds, or other similar securities, shall serve the same time as an officer, director, or employee of any member bank."[79]

Current explanations suggest that the Glass-Steagall Act serves to cartelize the commercial and investment banking industries by preventing firms in one industry from competing with firms in the other.[80] This lack of competition leads to higher prices for consumers of commercial banking and investment banking services and to less innovation in these businesses. If the dual banking system functioned as the existing theory predicts, competitive pressure from rival state regulators would have induced the federal government to liberalize the Act. Instead, when state nonmember banks began to show an interest in using the provisions of Sections 20 and 32 of Glass-Steagall to expand the services they offer customers,[81] Congress passed a law providing that "[t]he provisions of section 20 of the Banking Act of 1933 . . . and the provisions of section 32 of the Banking Act of 1933 . . . shall apply to every insured nonmember bank in the same manner and to the same extent as if such insured nonmember bank were a member bank."[82] This hardly matches the predictions of a model of competition in regulation.

3. *The Bank Holding Company Act*

The Bank Holding Company Act[83] is another example of federal preemption of state laws that limits jurisdictional choice and, thus, jurisdictional competition. The Bank Holding Company Act regulates the activities of any company that controls a bank,[84] re-

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78 12 U.S.C. § 377 (1982).

79 *Id.* § 78.

80 Macey, *Special Interest Groups Legislation and the Judicial Function: The Dilemma of Glass-Steagall*, 33 EMORY L.J. 1 (1984); Shughart, *A Public Choice Perspective of the Banking Act of 1933*, in THE FINANCIAL SERVICES REVOLUTION, *supra* note 26, at 87.

81 *See, e.g.*, Investment Co. Inst. v. FDIC, 815 F.2d 1540 (D.C. Cir.) (state nonmember insured banks allowed to affiliate with firms engaged in securities business), *cert. denied*, 108 S. Ct. 143 (1987).

82 Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 103, 101 Stat. 552, 566-67 (1987).

83 12 U.S.C. §§ 1841-1850 (1982).

84 For purposes of the Bank Holding Company Act (BHCA), a "bank" is any chartered bank that accepts demand deposits and makes commercial loans. *Id.* § 1841(c). The Supreme Court has strictly construed this statute. The result is that chartered banks that do not engage in *both* activities are not considered "banks" for purposes of the Bank Holding Company Act and are not subject to BHCA restrictions

gardless of whether the subsidiary bank is a national bank, a state member bank, or a state nonmember insured bank. Thus, even though a bank holding company owns only state banks operated within a single state, the Act subjects the holding company to regulation by the Federal Reserve Board. In fact, the Fed has exclusive jurisdiction among all federal and state agencies. This preemption is wholly inconsistent with the competitive principles supposedly underlying the dual banking system and grants the Fed complete control over the definition of the activities that a bank holding company's subsidiaries may conduct.

Moreover, the Bank Holding Company Act has significantly hindered the development of interstate banking. The Douglas Amendment to the Act prohibited interstate acquisitions of banks unless the state in which the acquired bank was located permitted the acquisition.[85] The recent development of regional interstate compacts has allowed for interstate banking, but only through the holding company format, and only with the permission of the state into which the holding company bank is expanding.[86]

In summary, the Supremacy Clause, because it allows the federal government to preempt numerous areas of state regulatory law, tends to minimize the principle of choice that Scott thought was so important to the development of efficient laws. In other words, *even if* banks were free to re-incorporate in any state where they found suitable laws, federal dominance in important aspects of banking regulations would still hamper the forces of jurisdictional competition.[87] As the literature on the jurisdictional competition for corpo-

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on interstate acquisitions or acquisitions by holding companies engaged in commercial activities (e.g., Sears). Such banks are referred to as "nonbank banks," "limited service banks," or "consumer banks." The Supreme Court upheld this "loophole" in Board of Governors v. Dimension Fin. Corp., 474 U.S. 361 (1986), and Congress closed it in the Competitive Equality Banking Act of 1987, Pub. L. No. 100-86, § 101(a)(1), 101 Stat. 551, 554 (1987). The closing of the loophole was designed to eliminate cheating on the cartel.

The Fed rushed to close the "nonbank bank" loophole as soon as it began to threaten the Fed's control over interstate banking. In fact, it is only from this interest group perspective that the Fed's effort to close the loophole can be explained in light of the Fed's general deregulatory stance.

85 Bank Holding Company Act of 1956, ch. 240, § 3(d), 70 Stat. 133, 135 (1956) (codified as amended at 12 U.S.C.A. § 1842(d) (West Supp. 1987)). *See* Northeast Bancorp, Inc. v. Board of Governors, 472 U.S. 159 (1985) (upholding constitutional authority of states to permit bank holding company expansion by holding companies of some states but not others).

86 *See generally* Miller, *Interstate Banking in the Court*, 1985 SUP. CT. REV. 179.

87 The current system of banking regulation, which federal regulatory law clearly dominates, represents precisely the type of uniformity that economists have attacked whenever there have been proposals for federally-imposed uniformity in corporation law. In contrast to the current jurisdictional competition in corporation law, which leads to the generation of an efficient set of corporation laws, movements such as national

rate charters has long assumed, the existence of any significant role for the federal government is incompatible with competition among federal and state regulators and among the states themselves.[88]

B. The Federal Deposit Insurance Corporation

Membership in the Federal Deposit Insurance Corporation is a competitive necessity for a commercial bank because, from an economic perspective, federally-funded deposit insurance acts as the functional equivalent of a massive government subsidy of bank risk taking.[89] Any bank attempting to compete in the banking services market without the benefit of this subsidy would suffer an overwhelming disadvantage. So long as the benefit of the insurance exceeds the costs (which take the form of a flat-rate premium based on the size of the insured bank's deposits and a requirement that insured banks comply with FDIC safety and soundness regnlations), any firm that attempted to compete in the banking services market without this subsidy would doom itself to failure.[90] This uniform scheme of federal regulation further reduces the prospects for effective competition in the provision of bank regulation.

It is not unreasonable, indeed it is prudent, for any insurer to demand and negotiate the right to monitor and to some extent control the risks taken by the parties it insures.[91] Our point here is not that such controls are inadvisable, but that they are inevitable in a system of federally-sponsored deposit insurance, and that such controls undermine the existing theory that regulators compete in the provision of banking laws. Of particular consequence are requirements that FDIC-insured banks must obtain prior regulatory approval of mergers and related combinations,[92] must have personnel acceptable to the federal regulators,[93] must comply with lending

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incorporation laws and ALI "Restatements" tend to destroy the beneficial effects of competition. *See generally* Baysinger & Butler, *supra* note 45.

88 Indeed the core of the debate in the literature on the jurisdictional competition for corporate charters concerns whether or not the federal government sbould assume an expanded role. All sides appear to agree that such a role would preclude competition among regulators. *See generally* Baysinger & Butler, *supra* note 22; Cary, *supra* note 22; Macey & Miller, *supra* note 39; Romano, *supra* note 40; Winter, *State Law, Shareholder Protection, and the Theory of the Corporation*, 6 J. LEGAL STUD. 251 (1977).

89 Recently some commentators have suggested that FDIC insurance is a subsidy for riskier banks, but not for banks with little risk of failure. *See* Fischel, Rosenfield & Stillman, *The Regulation of Banks and Bank Holding Companies*, 73 VA. L. REV. 301, 328 (1987).

90 Several states require state banks to purchase FDIC insurance. *E.g.*, FLA. STAT. ANN. § 658.38 (West 1984).

91 *See* Fischel, Rosenfield & Stillman, *supra* note 89, at 314-16.

92 12 U.S.C. § 1828(c) (1982); *see also* Macey & Miller, *Bank Failures, Risk Monitoring, and the Market for Bank Control*, 88 COLUM. L. REV. 1153 (1988).

93 12 U.S.C. § 1818(e)(4) (1982).

limits and restrictions on assets that they may own,[94] and must maintain certain minimum levels of capital and cash reserves.[95] All of these restrictions limit diversity and thus competition among federal and state banking regulators.

C. Geographic Restrictions on Bank Expansion

The ability of a state to create and allocate monopolies within its jurisdiction depends on its ability to exclude nonlicensed entry.[96] That is, the regulators must be able to segment the regulated markets geographically.

In banking regulation, one of the most important barriers to interstate competition is the Congressional belief that banking is an area traditionally regulated by the states. Thus, state regulations preventing entry by out-of-state banks appear safe from invalidation as violations of the dormant Commerce Clause.[97] With the McFadden Act, Congress authorized state regulations barring banks from branching across state lines.[98] The Act defers to state law on the important question of branch banking within a state and prohibits national banks from expanding beyond the borders of the state in which its principal office is located.

From an interest-group perspective,[99] the division of the nation into over fifty geopolitical banking markets is conducive to bank involvement in the political process. The scarcity of alternatives available to banks when faced with onerous state-specific or federal

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94 12 C.F.R. §§ 325.3-.4, 337 (1987).

95 *Id.*

96 This point is especially well illustrated by developments in nineteenth-century incorporation law. During the first half of the nineteenth century, states enjoyed a spatial (geopolitical) monopoly over the granting of the right to engage in particular corporate practices within their boundaries. Most states took advantage of this situation by selling special corporate charters to the highest bidders. The situation changed dramatically when the Supreme Court held that the Commerce Clause protected corporations chartered by one state but operating in another state from excessive regulation. Paul v. Virginia, 75 U.S. (8 Wall.) 168 (1868). This set the stage for jurisdictional competition in the lucrative corporate chartering business. States attempted to compete by offering liberal general corporation laws at relatively low prices, which undermined the value of special charters. Shortly thereafter, state legislatures stopped producing special charters—presumably because they were no longer of special value. *See* Butler, *supra* note 45.

97 Although federal regulations appear to envision the state's right to regulate branching, it is not completely clear that federal legislation protects state regulations forbidding branching by out-of-state banks against invalidation under the dormant commerce clause. See Miller, *Interstate Branching and the Constitution*, 41 BUS. LAW. 337 (1986).

98 McFadden Act, ch. 191, § 7c, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 36(c) (1982)).

99 *See generally* authorities cited *supra* notes 39 & 80.

regulations forces banks to lobby.[100] As the following subsection discussing the competitive equality doctrine shows, this pattern of regulation has created an ideal situation for state legislators and regulators. They have a captive market (a spatial monopoly), which until very recently was not threatened by meaningful entry from outside the existing geopolitical market. For federal banking regulators, the geopolitical division facilitates price discrimination in the sale of national bank charters.

D. The Competitive Equality Doctrine

The dual banking system has forced the courts as well as Congress to confront important issues related to the alleged competition between state and nationally-chartered banks.[101] In response to a perceived legislative concern that favoritism for one type of bank—state or national—would result in financial instability for the other, the Supreme Court developed the doctrine of competitive equality. The competitive equality doctrine prohibits the Comptroller of the Currency from enlarging the scope of certain activities of national banks—which would otherwise be permissible under federal law—beyond the precise limits a state allows for that state's chartered banks.[102] Thus, the doctrine limits the permissible activities and services of national banks located in a state to permissible activities and services of that state's state-chartered banks.[103] Stated in these basic terms, it is easy to understand how the competitive equality doctrine has stifled innovation in banking services, which in turn has tended to stabilize market share and thus defeat most of the

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100 The absence of a meaningful exit option forces bankers to use the political marketplace (or voice option) in attempting to alter their regulatory environment. For a description of this theory of social control, developed by Hirschman, see *supra* note 45. If one option is more costly or less effective at the margin, then the other option will be substituted. Thus, for areas of banking regulation where the exit option constitutes no credible constraint on regulators' actions, one would expect to see the affected parties resort to the voice option. That is, lobbying substitutes for exit. Of course, in order for the voice option to work, the regulators must respond to political pressures. Regulators are responsive to bank lobbying organizations and bank lobbyists are very well organized. In addition to national associations such as the American Bankers Association and the Independent Bankers Association, bank lobbying and service organizations exist in every state. In the absence of a meaningful exit option, the regulators benefit directly from the lobbying induced by geographic segmentation.

101 Scott, *supra* note 1.

102 In terms of the life of the dual banking system, the competitive equality doctrine is very old. The first clear statement of the doctrine is found in Tiffany v. National Bank, 85 U.S. (18 Wall.) 409 (1873).

103 *See, e.g.*, First Nat'l Bank in Plant City v. Dickinson, 396 U.S. 122 (1969) (definition of branch); First Nat'l Bank v. Walker Bank & Trust, 385 U.S. 252 (1966) (ability of national bank to branch); *cf.* Clarke v. Securities Indus. Ass'n, 107 S. Ct. 750 (1987) (competitive equality doctrine applies only to "core banking functions" of national bank).

benefits that one would expect to flow from the dual banking system.[104]

The greatest impact of the competitive equality doctrine is its restrictions on the ability of national banks to branch.[105] In addition to federal restrictions on national bank interstate branching, and despite the commerce clause,[106] national banks are subject to state law regarding the extent to which they may branch within the state in which they operate.[107] The history of the McFadden Act provides some insight into the political economy of this application of the competitive equality doctrine.

Under the National Bank Act of 1864, national banks could operate out of only one central office in the state in which the bank was located.[108] When state banks began to establish branch offices at the turn of the century, national banks became relatively unpopular. This situation continued until 1927 when Congress passed the McFadden Act, which amended the National Bank Act of 1864 to allow national banks to establish branches if state banks in that particular state enjoyed similar freedom.[109] As a result, the national banks follow state law regarding branching.

Although the McFadden Act at first may appear as a triumph of competition among regulators, upon closer inspection the law exemplifies cooperation among regulators, or, in terms of the preemption theory, the federal regulators allowed the states to continue to regulate branching because it was the best strategy for the federal regulators. First, the law had no effect at all on branching in states

104 For critiques of the competitive equality doctrine, see Fischel, Rosenfield & Stillman, *supra* note 89, at 335-36; Scott, *supra* note 1, at 41-42.

105 Another area of banking regulation affected by the doctrine of competitive equality is the administration of trusts by national banks. The Comptroller supervises the administration of trusts by national banks; however, as with branching, the Comptroller is bound to some extent by state law in an attempt to maintain competitive equality in the area of bank trusts powers:

> The Comptroller of the Currency shall be authorized and empowered to grant by special permit to national banks applying therefor, when not in contravention of State or local law, the right to act as trustee, executor, administrator, registrar of stocks and bonds, guardian of estates, assignee, receiver, committee of estates of lunatics, or in any other fiduciary capacity in which State banks, trust companies, or other corporations which come into competition with national banks are permitted to act under the laws of the State in which the national bank is located.

12 U.S.C. § 92(a) (1982).

106 Even after prohibiting interstate branching, Congress had the power to impose its own intrastate branching regulations on national banks but chose not to do so.

107 12 U.S.C. § 36(c) (1982).

108 Ch. 106, § 8, 13 Stat. 99, 101-02 (1864).

109 McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1228 (1927) (codified as amended at 12 U.S.C. § 56(1) (1982)). Initially, national banks could not branch outside of their home cities, even if state banks could branch statewide, but Congress removed this imbalance in the Banking Act of 1933, ch. 89, 48 Stat. 162 (1933).

where branching was prohibited by state law. National banks were still prohibited from branching after the passage of the new law. Second, the law removed any incentive that national banks might have had to obtain a state charter in states with liberalized branching rules. Finally, and most important, in those areas where local authorities desired to restrict competition and maintain cartel banking, they could continue to do so after enactment of the statute.[110] Thus a better explanation of the McFadden Act, with its judicially-grafted requirement of competitive equality, is that it stabilizes the regulatory cartel and, in fact, limits competition.[111] Case law construing the McFadden Act supports this view.

Much of this case law deals with the definition of a "branch bank." Several examples illustrate how the McFadden Act and the doctrine of competitive equality have maintained and reinforced the banking cartel. Courts have used the doctrine of competitive equality to justify a broad reading of the definition of "branch" under section 36(f) of the McFadden Act.[112] In essence, the courts have considered any activity that gives a bank an advantage over other banks in attracting customers as evidence that the activity constitutes a branch. This broad interpretation of branch limits certain activities that a bank might otherwise conduct away from its main office, depending on the state branching law.[113]

The lèading case applying the doctrine of competitive equality as a guide to the meaning of "branch" is *First National Bank in Plant City v. Dickinson*.[114] In *Plant City* the Comptroller granted permission to a Florida national bank to operate an armored car service and a shopping center receptacle—both staffed by tellers—for the receipt of deposits by customers. Florida law, at that time, prohibited branching of any kind. Consequently, the state banking regulators ordered the bank to stop providing the off-premises services. The bank argued that the depository did not "receive deposits" within the meaning of section 36(f) because bank customers had sigued an

110 States may adopt "home office protection" rules, which prohibit branching into the town or city where a bank maintains its home office, for example, or other such rules protecting local monopolies or cartels. *See infra* note 113.

111 Bert Ely argues that the McFadden Act totally abrogated federal control over branching (for national banks) to the states. Ely, *The Big Bust: The 1930-33 Banking Collapse—Its Causes, Its Lessons*, in THE FINANCIAL SERVICES REVOLUTION, *supra* note 26, at 41, 55 (labeling McFadden Act the "Unit Bank Perpetuation Act").

112 The McFadden Act defines a "branch" as including any "branch place of business . . . at which deposits are received, or checks paid, or money lent." McFadden Act, ch. 191, § 7, 44 Stat. 1224, 1229 (1927) (codified at 12 U.S.C. § 36(f) (1982)).

113 State laws prohibit branching with varying degrees of geographical restrictions. *See generally* Ginsburg, *Interstate Banking*, 9 HOFSTRA L. REV. 1133, 1152 (1981).

114 396 U.S. 122 (1969).

agreement stating that the transmittal of funds was not a "deposit" until delivered into the bank's hands.

The Supreme Court rejected the position of the bank and the Comptroller and held that the challenged facilities constituted "branches" under section 36(f):

> Because the purpose of the statute is to maintain competitive equality, it is relevant in construing "branch" to consider, not merely the contractual rights and liabilities created by the transaction, but all those aspects of the transaction that might give the bank an advantage in its competition for customers. *Unquestionably, a competitive advantage accrues to a bank that provides the service of receiving money for deposit at a place away from its main office; the convenience to the customer is unrelated to whether the relationship of debtor and creditor is established at the moment of receipt or somewhat later.*[115]

The Court's use of the doctrine of competitive equality to define "branch" as including any activity of a national bank that attracts customers from state banks is an obvious example of using the laws to protect competitors rather than to protect competition and to promote consumer welfare. That is, the McFadden Act allows regulators to protect the regulated.

The *Plant City* Court effectively prohibited a practice that clearly benefited consumers of banking services on the ground that it could harm state banks. Of course, it would not harm the state banks if they responded to the competitive threat by lobbying their state legislators for the same right to engage in the innovative activity instead of litigating to prevent national bank innovation. However, under the competitive equality doctrine, national banks would immediately benefit from the successful lobbying of state bank regulators because they could also provide the new services permitted state banks. Thus, the incentive to lobby state bank regulators declines: if either state banks or national banks lobby state regulators, any benefits will accrue to both types of banks.

As a result of the decision in *Plant City*, the competitive equality doctrine effectively limits the innovative activities of national banks—competition is limited to rates, hours, and traditional services.[116] Moreover, the doctrine also limits the advantages that state banks would expect to receive from lobbying for a change in

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115 *Id.* at 136-37 (emphasis added).

116 Numerous other cases illustrate the anticompetitive aspects of the competitive equality doctrine, but one particular case stands out. In Independent Bankers Ass'n of Am. v. Smith, 534 F.2d 921 (D.C. Cir.), *cert. denied sub nom.* Bloom v. Independent Bankers Ass'n of Am., 429 U.S. 862 (1976) (*IBAA*), the Comptroller contended that electronic fund transfer systems (EFTs) are not branches. The particular facts of the case indicate that the Comptroller had granted permission for a national bank to locate electronic fund transfer machines, some of which were on-line and some of which were not,

branching laws because the change automatically opens the door to the same activity by national banks. Thus, the competitive equality doctrine prevents cheating on the regulatory cartel. State regulators cannot provide an advantage to their state banks because the same advantage immediately accrues to the competing national banks.[117]

E. State "Wild Card" Statutes

The fifth force that prevents the realization of the benefits that consumers would derive from a truly competitive market for bank charters is the passage of state "wild card" provisions. These provisions which a majority of states have adopted, automatically grant state banks the same powers as national banks whenever a change occurs in the laws affecting national banks.[118] State legislatures, which generally do not meet throughout the year, have apparently enacted these statutes to provide themselves with a means of responding to changes in national bank powers that may occur while

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in grocery stores. Generally, bank customers could deposit and withdraw funds and to transfer funds among accounts.

In *IBAA*, the court asked whether the machines exhibited at least one indicia of a branch under section 36(f). The Comptroller's position was that the use of the machines involved not transactions, but instructions to consummate transactions. The court's response was that the Comptroller's distinctions were distinctions of form, not substance. When the customer delivers money, the bank has received a deposit. The court also said that the transfers among accounts and the payments of loans for credit card charges also constitute branching. The court, relying on *Plant City*, concluded that all account withdrawals were functional equivalents of checks paid under the definition of branching in section 36(f). Attacking the Comptroller's emphasis on the form of the transaction rather than the substance, the court held that EFT transactions are checks paid within the meaning of section 36(f), and concluded that

> regardless of private contract law and superficial form, any facility that performs the traditional bank functions of receiving or disbursing funds is a "branch" of a national bank within the meaning of section 36(f) if (1) the facility is established (*i.e.*, owned or rented) by the national bank, and (2) if it offers the bank's customers a *convenience* that gives the bank a competitive advantage over other banks (national or state) that do not operate similar facilities.

534 F.2d at 951-52 (emphasis added). The court evidently lost sight of whatever consumer welfare goals might be implicit in banking law. The flawed theory of competition underlying the "competitive" equality doctrine resulted in the court's holding that the automatic teller machine was a branch and thus not permitted under the applicable state law.

117 A major problem facing the banking industry, however, has been its inability to prevent nonbanking firms from intruding into traditional banking areas by offering only a limited range of banking services. Such firms have escaped the regulatory net of both state and federal bank administrators. The Comptroller recently limited the scope of the competitive equality doctrine as it applies to nonbanking activities of bank subsidiaries in order to permit banks to meet competition from nonbanks. *See* Clarke v. Securities Indus. Ass'n, 107 S. Ct. 750 (1987).

118 Thirty-three states have adopted some form of "wild card" statute. For a complete list, see W. SCHLICHTING, T. RICE & J. COOPER, BANKING LAW § 4.03[10] (1988).

the legislature is not in session. The wild card laws prevent the possibility of long periods during which state banks may suffer a competitive disadvantage because federal regulatory authorities have granted increased powers to national banks.

Like the competitive equality doctrine, these state wild card statutes appear at first blush to represent the ideal of competition in the dual banking system, because states immediately respond to innovations at the federal level.[119] However, as with the competitive equality doctrine, the competition is more apparent than real. Indeed, wild card statutes create a mirror image of the competitive equality doctrine. Wild card statutes reduce any incentive that banks have to lobby at the federal level for expanded bank powers because they must share any benefits achieved in the legislative process with all competitors.[120] In essence, state banks, through these wild card statutes, can free ride on the lobbying efforts of their national bank competitors. Thus, these state wild card statutes reduce the incentives of banks to lobby Congress for regulatory forbearance just as the federally-imposed competitive equality doctrine reduces the incentive of banks to lobby state legislatures for expanded powers. Together, these two forces inhibit regulatory innovation through dual system competition because they reduce the political support for innovation.

The federal competitive equality doctrine and the state wild card statutes channel lobbying to the regulatory level that is the most efficient vehicle for rent creation and rent extraction. Thus, the competitive equality doctrine encourages national banks as well as state banks to lobby state regulators for changes with regard to local concerns such as branching. Similarly, state wild card statutes encourage both state and national banks to lobby federal regulators for expanded bank powers.

Our overview of the important elements of bank regulation, taken together, form a strong case against the notion that there is effective competition among regulators. We now more precisely de-

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[119] Scott views the role of wild card statutes as valuable tools for enhancing "competition among agencies [that] causes the agencies to move in the direction of policies that allow broader operating authority and impose fewer constraints on profitability . . . [by] eliminating for the state banks the vicissitudes and costs of the legislative process." Scott, *supra* note 1, at 36.

[120] Nothing prevents national banks from lobbying state legislators for changes in state law. Similarly, nothing prevents state banks from joining national banks in lobbying Congress to expand national bank powers. The largest national trade associations of banks, the American Bankers Association [ABA] and the Independent Bankers Association of America [IBAA], include both national and state banks in their ranks. However, the ABA and IBAA frequently disagree on banking policies because the ABA represents the larger banks.

velop our theory of interaction among regulators in the dual banking system.

IV
A Theory of Regulatory Interaction in the Banking System: The Limits of Federal Preemption

Implicit in our criticism of the notion of competition in the dual banking system is the foundation for an alternative theory of the interaction among state and federal regulators in the dual banking system. This section synthesizes some of our observations about the organization of the dual banking system and develops a new theory. In our theory, regulators maximizing their political support, provide regulations to those who value them most as expressed by their willingness to provide political support in exchange for such regulations.[121]

Political-support-maximizing federal regnlators are characterized as the managers of a cartel designed to maximize the rent-seeking of regulated banks by maximizing the amount of the rents created by the overall regulatory structure. State banking regulators survive as effective participants in this rent-seeking process because some regulations are more effectively implemented at the state level. State regulators willingly participate because the federal regulators allow them to extract some of the rents that state-level regulations create. Nevertheless, federal regulators must view themselves as net beneficiaries of this delegation to state regnlators.

As cartel managers, federal regulators, using their constitutional and statutory powers, determine the amount of regulatory control they delegate to the state regulators. In general, the structure of banking regulation suggests that federal regulators have determined that regulations with purely local effects, such as the location of bank branches, are best settled by referring to state law, while regulations with national effects are best determined by considering their national political implications.

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121 A subset of the interest group theory of regulation addresses the economic incentives of government bureaucrats (rather than legislators), where the bureaucrats are delegated authority to enforce political bargains over time. Although bureaucrats are not perfect agents of the legislatures, it is clear that they have incentives to try to maximize the political support for themselves by pleasing legislators. Pleasing legislators often takes the form of pleasing the organized special interests that are repeat players in their dealings before the regulatory agency. Thus although the direct beneficiaries of administrative action are the regulated entities, the rents created are dissipated by transfers to legislators and bureaucrats. *See* Aranson, Gellhorn & Robinson, *A Theory of Legislative Delegation*, 68 CORNELL L. REV. 1, 26 (1982) ("federal agencies, bureaus, and commissions are as politicized as any other branch of the federal government, at least if the term 'politics' includes a consideration of the preferences of particular interest groups").

The dominant federal regulators realize that it is not in their interest, or the interests of state regulators, to compete in providing alternative sets of regulations. Rather, the dual banking system is simply a method of delegating the provision of legal rules to the regulators who value them the most—in other words, to the regulators who use them to generate the most political support. Instead of duplicating regulatory efforts, which one would expect to occur in a competitive system under the current dual system, state and federal regulators have divided up the task of regulating banks.

On most, but not all, important issues the federal regulations control. This naturally leads to the question of why, given that federal government regulators receive valuable political support from their ability to regulate banks, Congress has refrained from using its supremacy clause power to preempt all state regulation of banks, including branching regulations. In our view, the absence of federal preemption signifies a demand for regulations that vary appreciably from state to state, making the customized regnlations provided by individual states preferable from the perspective of the regulatory cartel. When the demand for regulation varies from state to state, the regulatory cartel can extract more rents through price discrimination[122] in the provision of customized state laws than through federal preemption.

A complementary explanation for the survival of state regulations in the face of federal preemption concerns the role of state regulation when state boundaries are used to divide a national market. In general, geographic segmentation of the market suggests that there is some legitimate role for state regulation. Federal regulators benefit from geographic segmentation of the market, but they have not yet determined how to reconcile geographic segmentation with the absence of state regulation. Thus, the federal regulators allow for limited state regulation to justify geographic segmentation.

The demand for regulation is particularly likely to vary from state to state with respect to intrastate geographical provisions when banks can achieve a spatial monopoly by obtaining rules that keep competitors from locating within their sphere of influence.[123] These state-by-state differences in the demand for regulation ex-

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122 The necessary conditions for successful price discrimination include segmentation of a product market according to different elasticity of demand for the product, and the prevention of arbitrage between customers in the lower price segment and those in the higher price segment. F. SCHERER, *supra* note 57, at 253. To the extent that the demand for banking regulation varies across states, the first condition is met. And, of course, under current law, it is impossible to purchase a bank charter in one state and operate the bank in other states.

123 *See supra* notes 110 & 113.

plain both why state regulations control branching and why bank charters authorize the operation of banks in only one state.

The ability to control bank expansion through branching enables local regulators to perpetuate local monopolies. Because of historical, demographic, economic, or geographical reasons, each state jurisdiction is different and different branching regulations are needed to maintain existing (political-support-maximizing) cartels. In fact, states have adopted some very odd branching laws.[124] In Utah, for example, banks that had their headquarters in one county could branch in incorporated, but not unincorporated, areas of other counties.[125] In New York, banks may branch statewide but not in counties with less than 50,000 inhabitants where other banks have their headquarters.[126] Missouri prohibits banks from operating more than one place of business for the exercise of fiduciary services.[127] Finally, some states do not allow branch banking at all.[128]

The varied system of state branching laws evolved as banking regulators responded to the particular demands of the banks in each state. The federal government could not possibly duplicate this incredibly diverse system of state branching laws. Therefore, federal regulators more efficiently create and extract rent by delegating the regulation of this aspect of banking to local regulators. Predictably, rational, political-support-maximizing Congressmen have responded to the desire for localized regulation of branching by ceding this issue to state legislatures. By contrast, where the political-support-maximizing solution entails a single rule for the entire country, the optimal outcome for the regulated entites is for federal law to prevail because it generally costs less for interest groups to achieve their goals by lobbying Congress for a single national rule than it is for them to lobby fifty state legislatures.[129]

A similar interpretation applies to the division of the nation into fifty-one separate banking markets, where a bank may obtain a char-

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124 We make no attempt to explain why different states adopt different branching laws except to say that the pattern strongly suggests a desire to protect local monopolies.

125 *See* First Nat'l Bank v. Walker Bank & Trust Co., 385 U.S. 252 (1966). Utah has since repealed this restriction and now permits branching more freely. UTAH CODE ANN. § 7-1-708 (1988).

126 N.Y. BANKING LAW § 105 (McKinney 1988); *see also* Independent Bankers Ass'n v. Marine Midland Bank, 757 F.2d 453 (2d Cir. 1985), *cert. denied*, 476 U.S. 1186 (1986).

127 MO. ANN. STAT. § 362.107 (Vernon 1988).

128 *E.g.*, ILL. ANN. STAT. ch. 17, para. 3406 (Smith-Hurd 1987); *see also* F. MISHKIN, THE ECONOMICS OF MONEY, BANKING, AND FINANCIAL MARKETS 182 (1986) (noting those states that allow unit banking).

129 This result is offset, to some extent, by the more difficult organizational problems, such as formation of an association and free riding, faced by the larger organizations often needed to lobby at the national level.

ter from either the federal government or the state government, but where even national banks are limited to operating in one state. Federal preemption of bank chartering would necessarily eliminate any remaining restrictions on the geographic expansion of banks. The ability to expand in an unlimited fashion would destroy the remaining local monopolies and reduce the franchise value of existing banks dramatically. The limits on geographic expansion are a major source of the rents bank regulation creates. The existing banks know this and they certainly would resist any efforts to destroy geographic boundaries. Moreover, the regulators know that their power is derived from the rents they can create, and nationwide banking would increase true competition for charters and erode rents.

Geographic restrictions also add stability to the dual banking system because they provide a means for national bank regulators to engage in price discrimination when allocating national bank charters. In order for the national bank regulators to succeed, the bank regulators in each state must cooperate by simultaneously restricting their own output of charters. The threat of federal preemption forces state regulators to cooperate with federal regulators.

This view of bank chartering also suggests why the federal banking regulators have allowed for the development of interstate banking through the bank holding company, but not through interstate branching.[130] For federal regulators and most existing national banks, the Bank Holding Company Act achieves the dual purposes of maintaining the geographically segmented markets and imposing activity restrictions on state banks within those markets.

In spite of all the evidence of apparent stability in the dual banking system, the system is under considerable pressure from major forces beyond its control.[131] Significant developments in technology challenge the logic of any type of geographic restraints. Automatic teller machines can allow individuals to conduct their banking activities regardless of state boundaries. As the potential benefits to consumers from interstate banking networks becomes more apparent, it will become more and more difficult for the banking industry and banking regulators to generate public interest arguments in favor of maintaining the current system.[132]

Similarly, the 1970s and 1980s have witnessed the encroachment of nonbanking firms into the traditional domain of banks. Nonbanking firms have steadily eroded banks' market share in com-

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130 *See supra* notes 83-86 and accompanying text.

131 *See generally* Miller, *supra* note 4.

132 *See generally* Peltzman, *supra* note 6 (political-support-maximizing legislators balance benefits from passing interest group legislation against probable backlash at ballot box).

mercial and automobile loans.[133] Nonbanking firms have also developed substitute products such as cash management accounts and even nonbank safe deposit protections. The presence of these substitute products reduces the value of banking regulation. Unless regulators implement some changes, banks will continue to see their position of primacy in the financial system deteriorate.

Recognizing this market revolution, federal regulators have generally supported expanded bank powers in recent years.[134] This reinforces the view that the regulated entities and regulators are the true beneficiaries of banking regulations. Even more significant evidence in support of this position is that bank regulators have recently proposed expanding some of their regulatory authority to include control of companies providing products similar to those offered by banks.[135]

Perhaps more important to the future of the dual banking system has been the development of foreign competition. Foreign banks are generally allowed much greater securities and commercial powers than United States banks. The impact of foreign banks on the American banking market is enormous. In 1971, seven of the top twenty-five banks in the world were American, but by 1986, that figure was down to two.[136] Even in America, domestic banks have lost much business to foreign banks. During the last ten years, financial assets held by foreigu bank offices have risen by 400 percent, more than twice the percentage increase for domestic banks.[137]

In summary, the long term stability of the dual banking system depends on the ability of banking regulators and Congress to respond to exogenous shocks. Regnlators will probably not find it politically viable to continue to close loopholes and expand their regulatory domain.

These observations about the pressures on the dual banking

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133 The emergence of entites such as General Motors Acceptance Corporation and Ford Motor Credit has affected the banking industry's share of automobile loans. The emergence of the commercial paper market as a substitute for bank loans to large corporations has also played a role. Note, *A Conduct-Oriented Approach to the Glass-Steagall Act*, 91 YALE L.J. 102 (1981).

134 *See supra* note 117.

135 *See, e.g.*, E. CORRIGAN, FINANCIAL MARKET STRUCTURE: A LONGER VIEW (1987) (proposal to impose reserve requirements on money market mutual funds).

In 1986, Chase Manhattan and several other major banks threatened to surrender their charters in order to offer additional financial services that banks were prohibited from supplying, but decided against such a move because they would lose access to the payments system. To have access to the payments system, a bank must be a member of the Federal Reserve System, which in turn requires membership in the FDIC, which in turn subjects it to all of the uniformity regulations imposed on member banks.

136 *The Top Banking Companies in the World*, Am. Banker, July 31, 1987, at 36.

137 FEDERAL DEPOSIT INS. CORP., MANDATE FOR CHANGE: RESTRUCTURING THE BANKING INDUSTRY 16 (1987).

system provide strong support for our alternative theory. Our analysis suggests that regulators in the dual banking system have been unable to respond effectively to changes in banking markets because the elaborate interest-group bargain reflected in the current structure of banking regulation is designed to maintain cartel banking in a static world. Indeed, because supporters of the dual banking system often view it as a source of regnlatory innovation in response to market forces, the strongest indictment of the traditional theory of the dual banking system is the observation that regnlators have responded ineptly to a dynamic market.

V
MONOPOLY VERSUS COMPETITION IN THE MARKET FOR BANKING LAWS AND REGULATIONS

The preceding analysis has laid bare the myth that effective competition exists in the dual banking system. The current threats to the stability of the dual banking system and the conclusion that the current dual banking system lacks any redeeming features force a consideration of alternative structures in the regulation of the banking industry. We consider two alternatives here, both of which appear unambiguously superior to the current regime. We wish to emphasize at the outset, however, that we harbor no illusion that either of these policy alternatives is likely to emerge so long as special interests continue to dominate the regulatory environment.

The first alternative regulatory structure, exclusive federal regulation, would force states to relinquish their roles as regulators of banking activities through federal preemption. The preceding analysis of the political economy of the dual banking system suggests that state banking regulation serves no productive role in achieving the safety and soundness goals of banking regulation. Moreover, besides being unproductive, state regulation in the presence of federal deposit insurance may make state competition undesirable and, thus, federal preemption desirable.

The existence of federal deposit insurance creates incentives for state regulators to adopt regulations that threaten the stability of the banking system. For example, if state banking regulators authorize certain unsound banking practices that ultimately lead to the failure of state banks, federal deposit insurance still protects the resident depositors of that state. The costs of the risks that state banking regulators authorize and state banks undertake are borne by all depositors in the nation. Local depositors, whom state regulations are supposed to protect, suffer no consequences but the state regulators can be expected to take political credit for the local benefits associated with liberalized banking laws even where such liberaliza-

tion increases the probability of bank failure.[138] In other words, state banking regulators confront a moral hazard[139] that at least some of them will likely exploit to gain political capital by increasing the opportunity for shareholders to profit by engaging in excessive risk taking.[140] This cost of the dual banking system, when coupled with the failure of the dual banking system to generate efficient laws, suggests the desirability of complete federal preemption of state banking regulations.

While centralization of banking regulation at the national level is certainly appealing in light of the preceding analysis, there are significant costs associated with the continued centralization of bank regulatory authority. Such centralization is tantamount to the creation of a monopoly regulatory agency. In an industry already dominated by special interests and entrepreneurial legislators, a monopoly provider of banking powers would have no incentive to liberalize the restrictions on entry into the banking industry, to develop innovative ways to solve contracting problems banks face, or to respond rationally to technological changes. Instead, increasing centralization will likely lead only to continued stagnation of banking laws.[141] Thus, consolidation of regulatory authority does not appear to be the optimal response to the deficiencies of the dual system. Indeed its only advantage appears to be that it would mitigate the moral hazard problem facing banking regulators by giving complete authority to federal regulators, who presumably have a slightly greater incentive to enact rules that will penalize banks for excessive risk-taking.

Our second alternative to the present system is to eliminate completely the preemptive role of the federal government, thereby allowing for state competition in the provision of banking laws and regulation. This approach would require several radical alterations in current banking structure, including the imposition of risk-adjusted deposit insurance and the repeal of the McFadden Act's interstate and intrastate branching restrictions. Under such a system no real need for federal chartering would exist because state banks would be allowed to branch regardless of geopolitical bounda-

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138 *See supra* text accompanying note 87.

139 Miller, *supra* note 4, at 19.

140 An example of this problem is the recent intervention by the Speaker of the House of Representatives, Jim Wright of Texas, to prevent federal regulatory authorities from closing insolvent savings and loan associations in his home state. *See* N.Y. Times, June 22, 1987, at A12, col. 5. The benefit of propping up an ailing thrift accrues locally, but the costs to the insurance fund are borne nationwide.

141 For historical evidence in support of the proposition that monopoly providers of laws tend to lag behind the changing needs of the business community, *see* Butler, *supra* note 45, at 166; L. GOWER, J. CRONIN, A. EASSON, & LORD WEDDERBURN, GOWER'S PRINCIPLES OF MODERN COMPANY LAW 53-57 (4th ed. 1979).

ries.[142] This would lead to the development of a truly national market for banking laws which would exhibit all of the beneficial aspects of the current robust jurisdictional competition in the market for corporate charters.

Because of the moral hazard problem confronting state regulators, the first requirement in any move toward state competition is to modify deposit insurance so that each bank's deposit insurance premium reflects the true risk of default by that particular bank. Although government regulators could never perform such a task,[143] lawmakers could require banks to engage in certain activities that would force the market to evaluate the default risk of a bank's deposits. One attractive proposal would require banks to issue short-term subordinated debentures (lower in priority than the depositors claims) in an amount equal to a certain percentage of their capital (or net worth) on a regular basis.[144] As the capital markets adjusted rates on the debentures to reflect the riskiness of the bank, regulators would then adjust the deposit insurance premium (perhaps instantaneously) in the same direction. Such risk adjusted premiums would force banks to internalize the costs of their risk taking in the form of both higher interest payments on the debentures and higher insurance premiums.

If banks are forced to internalize the costs of their risk taking, the moral hazard problem currently facing banks and state bank regulators disappears. Regulators cannot benefit bankers by permitting them to engage in excessively risky activities if the bankers must absorb the costs of such excessive risk taking themselves.

An alternative, more radical, solution to the moral hazard problem that state banking regulators face would be the dissolution of the federal government's monopoly over deposit insurance. Although there is some controversy over the ability of private insurers to provide protection against the system-wide risk imposed by a depression,[145] private deposit insurers would clearly do a better job than federal regulators at structuring insurance contracts that en-

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142 Alternatively, national banks would be subject to the safety and soundness regulations of the state where they are headquartered, but also free to alter their national charter to change their headquarter state.

143 For an excellent discussion of the shortcomings of risk-based premiums established by the federal deposit insurance monopolies, see Scott & Mayer, *Risk and Regulation in Banking: Some Proposals for Federal Deposit Insurance Reform*, 23 STAN. L. REV. 857, 890-95 (1971).

144 For a discussion of several options to correct the moral hazard inherent in the current FDIC rate structure, see Scott, *Deposit Insurance—The Appropriate Roles for State and Federal Governments*, 53 BROOKLYN L. REV. 27, 33-38 (1987).

145 For a thorough analysis of the structural flaws of the current federal deposit insurance system that argues for adjustment to the federal system rather than replacement with private deposit insurance, see G. BENSTON, ET AL., *supra* note 3, at 81.

courage banks to control their default risk and thus reduce the overall risk to the banking system.[146]

Regardless of its source (government or private sector), competitively priced, risk-adjusted deposit insurance sets the stage for states to compete in the market for the provision of safety and soundness regulations. Full implementation of competition would also require the elimination of geographic restrictions on branching, thereby allowing banks chartered in one state to engage in deposit taking in all other states.

In response to these reforms, states would have to compete in the provision of safety and soundness regulations to lower the cost of capital (and the cost of deposit insurance) for locally-chartered banks. Risk-adjusted insurance rates would prevent the possibility of a destructive "race to the bottom." Whenever a state adopted regulations (such as granting new bank powers, increasing lending limits, or lowering reserve requirements) that threatened to increase the risk of failure of banks operating under its laws, banks chartered by that state would suffer from higher deposit insurance premiums. This would place banks chartered in that state at a competitive disadvantage throughout the country. Banks would either exit from the chartering state, lobby for changes in the state law, or do nothing. The latter strategy would probably draw the attention of firms specializing in the acquisition of inefficiently managed banks and, ultimately, lead to a takeover and reincorporation in another state.[147] Regardless of the managerial strategy, risk-adjusted deposit premiums impose a self-correcting mechanism on states that fail to adopt adequate safety and soundness regulations.

Under this regulatory structure, managers would select a set of state laws that impose the optimal amount of safety and soundness regulation. Selecting a particular state law (and issuing a credible promise not to remove to another state) could be important because insurers' might have doubts about the enforceability of certain provisions of the insurance contract. Bank managers would voluntarily accept the restriction in order to improve the market value of the firm. In recognition of the need for bonding, firms would probably

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146 *See generally* Ely, *Private Sector Depositor Protection Is Still a Viable Alternative to Federal Deposit Insurance*, ISSUES BANK REG., Winter, 1986, at 40; O'Driscoll, *Deposit Insurance in Theory and Practice*, in THE FINANCIAL SERVICES REVOLUTION, *supra* note 26, at 165.

147 Currently, certain states have statutes that prohibit corporate acquisitions of commercial banks. *See* Brickley & James, *The Takeover Market, Corporate Board Composition, and Ownership Structure: The Case of Banking*, 30 J. L. & ECON. 161 (1987). The regulatory structure our proposal envisions relies on market forces (including the market for corporate control), not regulations, to control state regulators and bank managers. The role for the market for corporate control, however, is reduced to some extent by the use of risk-adjusted premiums in deposit insurance as a governance mechanism.

prefer states that imposed some type of limitation on the ability of a troubled firm to exit. This would provide a valuable and important signal to the market. Similarly, there is a concern that radical changes in state regulatory policy could increase the risk of bank failures. As a result, banks would tend to incorporate in states that had a tradition of stability in banking regulations and where the state's economy was especially dependent on the banking industry.

Eventually, the imposition of true jurisdictional competition and competitive, risk-adjusted deposit insurance could also lead to the demise of state safety and soundness regulations as they are replaced by the privately negotiated insurance contract. Private "regulation" by insurers could be much more effective than state regulation. Insurers would not worry about sudden changes in a states' banking regulations because the insurance contract would control. For example, private insurers could impose their own lending limits and reserve requirements. State banking regulations could become enabling statutes—similar to corporation laws—that allow banks to do whatever their insurers permit.

At least three important benefits would flow from the creation of a competitive market for bank charters. First, it would destroy the regulatory cartel that has dominated banking regulation since at least the passage of the McFadden Act in 1927. Only market demand would limit entry into the banking industry.[148]

Second, this new banking system would result in a safer and sounder banking system than the current system because it would allow banks to ignore geopolitical boundaries for all of their services. This would allow banks and thus consumers to take better advantage of the benefits of geographic diversification.[149] Banks can achieve greater stability through interstate branching of a single bank than through interstate banking holding companies.

Third, this new banking system would provide the greatest potential for beneficial innovation in the provision of bank regulation.

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148 For a discussion of how the long-refuted notion of ruinous competition motivated many New Deal regulations and why banking is the only area of such regulation that is still enforced, see Fischel, Rosenfield & Stillman, *supra* note 89, at 302-05. Ruinous competition never justified restricting bank competition through banking regulation.

149 Interstate bank activities benefit the public by increasing geographic diversification and increasing competition in local financial markets. *See generally* S. HORWITZ & G. SELGIN, INTERSTATE BANKING: THE REFORM THAT WON'T GO AWAY (CATO Institute Policy Analysis 1987); Note, *Interstate Banking Restrictions Under the McFadden Act*, 72 VA. L. REV. 1119, 1147 (1986) (authored by David Freeman). Interstate banking by bank holding companies is not as effective in achieving these benefits. *See generally* Rhoades, *Interstate Banking and Product Line Expansion: Implications from Available Evidence*, 18 LOY. L.A.L. REV. 1115, 1150-53 (1985) (discussion of inapplicability of portfolio theory to bank holding company diversification).

The reason for this is that under the current system there is no process for regulators or legislators to discover the "best" banking laws and there is no process identifying the circumstances that call for a change in the laws. Under a system of jurisdictional competition states could learn from each other's mistakes and profit from the experience of others, thus leading to more rapid innovation in the provision of regulation and greater responsiveness to exogenous shocks to the system. Only through the trial and error process of a competitive market can the optimal combination of laws that promote efficiency and safety and soundness be discovered.[150]

Conclusion

The preceding analysis has shown that beneficial competition between federal and state regulators in the dual banking system is only a myth. The primary force in the destruction of the competition is the supremacy clause, which enables the federal government to preempt diversity and impose uniformity, as it has done by preempting state regulation of reserve requirements, investment banking services, and bank expansion into different product and geographic markets through holding companies. But there are other important forces, particularly the necessity for federal control of bank risk taking because of the presence of federal deposit insurance, that reinforce the supremacy clause and reduce the payoff to state or federal diversification.

There is little, if any, productive competition in the dual banking system. The relationship among the regulators in the dual banking system reflects the dominant power of the federal government, which chooses to delegate regulatory authority so as to maximize its own political support from the relevant interest group coalitions. Federal regulation is limited only by the inability of federal regulators to regulate effectively the few areas best controlled by state regulators.

We have observed that the absence of competition among regulators in the current system is in fact all for the good. Competition is undesirable under the current system of federally-subsidized, fixed-rate deposit insurance because of the perverse incentives such an insurance scheme provides for state regulators. The insurance scheme induces regulators to promulgate rules that permit excessive and unconstrained risk taking by federally-insured state banks because most of the benefits from such a policy are borne locally,

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150 For a classic definition of competition as a process, see F. Hayek, *The Meaning of Competition*, in Individualism and Economic Order 92 (1948).

while the costs are spread across the entire range of federally insured banks.

Thus, desirable competition among regulators is only possible if banks are required, through the imposition of risk-adjusted deposit insurance, to internalize the costs of excessive risk taking. If this were allowed to occur, then states would have incentives to compete with one another to offer banks the optimal mix of safety and soundness regulation that would permit the firms to minimize their costs of capital. Banks chartered in states that condoned excessive risk taking would have to bear the costs of their actions in the form of higher insurance rates and/or higher capital costs on uninsured deposits. In this regard, the insurance contract, not government regulators, is the ultimate source of efficient regulations.

Finally, we show that banks must be allowed to charter freely among states in order for this competitive process to work. Thus, the current restrictions on bank's geographic expansion also must be removed in order to have truly productive competition in the generation of efficient banking laws and regulation.

At present, healthy competition in the dual banking system of the sort imagined by the many supporters of the current system is a myth, not a reality. This Article shows that achieving the elusive goal of regulatory competition would require profound and heretofore unrecoguized changes in the structure of the nation's banking regulations. Those firms and regulators who enjoy the political rents from the current system are unlikely to greet the necessary changes with enthusiasm.